

Message Text

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ACTION EA-12

INFO OCT-01 EUR-12 ISO-00 SP-02 USIA-06 AID-05 EB-08
NSC-05 TRSE-00 SS-15 STR-07 OMB-01 CEA-01 CIAE-00
COME-00 FRB-03 INR-10 NSAE-00 XMB-02 OPIC-03
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FM AMEMBASSY TOKYO
TO SECSTATE WASHDC 5534
INFO AMEMBASSY BRUSSELS
AMEMBASSY PARIS

C O N F I D E N T I A L SECTION 1 OF 2 TOKYO 2997

USEEC

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E.O. 11652: GDS
TAGS: ECON, JA
SUBJECT: ECONOMIC PROSPECTS: INVENTORY OUTLOOK NOT BRIGHT.

1. SUMMARY. FOLLOWING THE ANNOUNCEMENT OF THE GOVERNMENT'S OFFICIAL FY 78 FORECAST, A CONTROVERSY HAS DEVELOPED OVER THE OUTLOOK FOR PRIVATE INVENTORY INVESTMENT AND THE CHANGING CHARACTERISTICS OF THE INVENTORY CYCLE. MOST PRIVATE FORECASTERS ARE BOTH PESSIMISTIC AND PUZZLED OVER THE PROJECTED 24.6 PERCENT NOMINAL GROWTH IN INVENTORY INVESTMENT, AND DIFFERENCES AMONG KEY GOVERNMENT OFFICIALS ABOUT THE TIMING AND SIGNIFICANCE OF AN END TO INVENTORY ADJUSTMENT HAVE ALSO EMERGED. YET ASSUMING AN INCREASE OF 21 PERCENT IN REAL TERMS, INVENTORY INVESTMENT WILL CONTRIBUTE ONLY 0.4 PERCENT TO THE FORECAST 7.0 PERCENT INCREASE IN FY 78 GNP. THE RISK IS THAT THE DISCUSSION OVER STOCK REBUILDING TENDS TO OBSCURE MORE FUNDAMENTAL ECONOMIC PROBLEMS SUCH AS UNCERTAINTY
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OVER THE OUTLOOK FOR FINAL DEMAND. END SUMMARY.

2. EPA DIRECTOR GENERAL MIYAZAWA ON JAN. 28 TOLD THE DIET THAT THE INVENTORY ADJUSTMENT PROCESS COULD BE OVER BY MARCH OR APRIL. WHEN ASKED ABOUT THIS AT A PRESS CONFERENCE, BOJ GOVERNOR MORINAGA WAS SLIGHTLY LESS OPTIMISTIC, SAYING THAT COMPLETION OF

THE PROCESS BY THE END OF FY 77 IS UNLIKELY. MITI MINISTER KOMOTO SUB-SEQUENTLY TOLD THE DIET IT WOULD BE SUMMER AT THE EARLIEST BEFORE THE PROCESS ENDED. KOMOTO WENT ON TO PAINT THIS DEVELOPMENT IN A PESSIMISTIC LIGHT CLAIMING THAT IT WAS MORE THE RESULT OF WEAK PRODUCTION THAN OF STRENGTHENING SALES. IN CONTRAST, EPA'S EXPLANATION OF THE EVIDENCE FOR COMPLETION OF THE INVENTORY ADJUSTMENT PROCESS HAS GENERALLY STRESSED THE POSITIVE ELEMENTS OF A PICKUP IN SHIPMENTS IN THE LAST TWO OR THREE MONTHS AND A RISE IN PRICES FOR SOME RAW MATERIALS SINCE THE END OF 1977. DIFFERENCES APPEAR MORE MUTED IN THE OFFICIAL PUBLICATIONS OF EPA AND BOJ. BOTH THE EPA AND BOJ IN THEIR LATEST MONTHLY ASSESSMENTS SEE OVERALL PROGRESS IN GETTING INVENTORIES UNDER CONTROL BUT BOTH ARE CHARY OF CALLING THE TIMING FOR THE END OF THE PROCESS (SEE TOKYO 2522).

3. SOME CONTROVERSY SURROUNDS THE OFFICIAL PROJECTION OF A NOMINAL 24.6 PERCENT INCREASE IN STOCKBUILDING (ABOUT 21 PERCENT IN REAL TERMS IN FY 78), WHICH SOME PRIVATE FORECASTERS THINK IS TOO HIGH. EVEN THIS VERY LARGE INCREASE IN INVENTORY ACCUMULATION WOULD ADD ONLY ABOUT 0.4 PERCENTAGE POINTS TO REAL GROWTH, AND WEAKER ACCUMULATION WOULD NOT GREATLY AFFECT THE CONFIDENTIAL

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FINAL OUTCOME FOR THE WHOLE ECONOMY. THE LARGER ISSUE THAT IS BEING RAISED IS WHETHER EPA IS OVER-EMPHASIZING THE IMPORTANCE OF THE INVENTORY CYCLE AS AN EXPLANATION FOR FAILURE OF THE JAPANESE ECONOMY TO RE-ESTABLISH ORDERLY GROWTH AND POSSIBLY NEGLECTING MORE FUNDAMENTAL STRUCTURAL IMBALANCES THAT HAVE EMERGED IN ADJUSTING TO HIGH ENERGY PRICES AND SLOWER GROWTH.

4. AN EXTENDED SECTION OF THE MOST RECENT MONTHLY EPA REPORT EXAMINES AT LENGTH THAT AGENCY'S VIEW ON THE ROLE THAT STOCK ADJUSTMENT HAS PLAYED SINCE THE ENERGY CRISIS. ADOPTING WHAT IS ESSENTIALLY A HICKSIAN MULTIPLIER ACCELERATOR ANALYSIS, EPA ARGUES THE DECELERATION OF GROWTH AFTER THE FIRST QUARTER OF 1977 WAS THE RESULT OF AN ABORTED INVENTORY ACCUMULATION PROCESS. AS EPA SEES IT, ACCUMULATION IN LATE 1976 WAS NOT MATCHED BY A CORRESPONDING RISE IN FINAL DEMAND, HENCE A SECONDARY INVENTORY CORRECTION WAS REQUIRED. THIS PROCESS IT NOW BELIEVES IS NEARING THE END.

5. IN A DETAILED STATISTICAL EXAMINATION OF INVEN-

TORY LEVELS, EPA CONCLUDES THAT THE RATIO OF INVENTORIES
OF FINAL GOODS TO SHIPMENTS, AS MEASURED
BY A COMPOSITE INDEX OF INVENTORIES AT THE MANU-
FACTURING LEVEL AND AT THE DISTRIBUTORS LEVEL, ARE
NOW BELOW THEIR TREND VALUE FOR THE PAST TEN YEARS.
INVENTORIES OF SEMI-FINISHED GOODS IN RELATION TO
SHIPMENTS, AS MEASURED BY A COMPOSITE INDEX OF
INVENTORIES OF SEMI-FINISHEDA GOODS,
AT BOTH THE MANUFACTURERS LEVEL AND THE DISTRIBUTORS LEVEL,
ARE ESTIMATED TO BE RIGHT ON
THEIR TREND VALUE. THE TREND LINES CALCULATED BY
EPA SHOW A DECLINING TEN-YEAR TREND FOR FINAL GOODS
INVENTORIES AND A RISING TEN-YEAR TREND FOR SEMI-FINISHED GOODS.
THE ESTIMATES OF INVENTORIES/SHIPMENTS RATIOS
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EMPLOYED IN THIS EPA STUDY ARE BROADER THAN THE
MONTHLY SERIES ON INVENTORIES/SHIPMENTS WHICH ONLY
ENCOMPASSES INVENTORIES OF FINAL AND SEMI-FINISHED
GOODS OF MINING AND MANUFACTURING INDUSTRIES AT
THE MANUFACTURERS LEVEL.

6. EPA NOTES THAT, DESPITE ITS ESTIMATES THAT
INVENTORIES ARE NOW CLOSE TO TREND LEVELS SURVEYS
OF BUSINESS SENTIMENT CONSISTENTLY REVEAL INVENTORIES

NOTE BY OC/T: #AS RECEIVED.

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C O N F I D E N T I A L SECTION 2 OF 2 TOKYO 2997

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C O R R E C T E D C O P Y (TEXT)

EXCEED DESIRED LEVELS. EPA SAYS THIS DISCREPANCY IS ACCOUNTED FOR BY (A) THE EVAPORATION OF WHOLESale PRICE INFLATION WHICH HAS ELIMINATED ANY SPECULATIVE REASONS TO HOLD INVENTORIES, (B) RELATIVELY HIGH REAL INTEREST RATES GIVEN THE WEAK TREND OF WHOLESale PRICES AND (C) A DOWNWARD SHIFT OF APPROPRIATE INVENTORY LEVELS OWING TO EXPECTATIONS OF LOWER GROWTH.

7. IN DISCUSSING PROSPECTIVE DEVELOPMENTS, EPA ANALYSIS STRESS THAT AN ENDING OF THE INVENTORY ADJUSTMENT WOULD REMOVE A DRAG ON PRODUCTION (THE NEGATIVE ACCELERATOR EFFECT) EVEN IF POSITIVE ACCUMULATION DID NOT IMMEDIATELY COMMENCE. WHETHER OR NOT A POSITIVE ACCELERATOR PHENOMENON DEVELOPS, AND IF IT DEVELOPS, WHETHER IT WILL BE SUSTAINED, WILL DEPEND ON THE COURSE OF FINAL AUTONOMOUS DEMAND.
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8. TAKAO AKABANE, UNTIL JANUARY DIRECTOR OF DOMESTIC RESEARCH DIV. IN EPA'S RESEARCH BUREAU, IS GENERALLY CONSIDERED TO BE THE MAIN EXPOSITOR OF EPA'S THINKING ON THE INVENTORY CYCLE. IN A RECENT CONVERSATION, AKABANE TOLD EMBOFF THAT EPA DIR. GEN. MIYAZAWA AND DIR. GEN. MIYAZAKI HAD BECOME "DISCIPLES" OF THIS VIEW.

9. MANY PRIVATE ECONOMISTS, HOWEVER, VIEW THE EPA THESIS SKEPTICALLY. THEY SEE THE COLLAPSE OF INVENTORY BUILDING AS A RESULT OF THE SHIFT FROM HIGH TO LOW GROWTH AND A REACTION TO THE STRUCTURAL MALADJUSTMENTS THIS AND THE OIL CRISIS HAVE CREATED. THEY BELIEVE THERE HAS BEEN A PERMANENT SHIFT TOWARD ECONOMIZING ON INVENTORIES AND THAT EVEN WHEN STOCKS ARE FULLY ADJUSTED A REBOUND IN STOCK BUILDING CANNOT BE EXPECTED. THESE PRIVATE ANALYSTS ALSO QUESTION EPA'S STATISTICAL EVIDENCE ABOUT THE EXTENT TO WHICH INVENTORIES HAVE ALREADY ADJUSTED TO DESIRED LEVELS. DESPITE SOME EVIDENCE OF A LIQUIDATION OF EXCESS INVENTORIES AT THE

DISTRIBUTOR'S LEVEL, THEY SEE SIGNS OF A PILEUP OF INVENTORIES OF INTERMEDIATE GOODS AND RAW MATERIALS. NONE OF THE PRIVATE FORECASTERS CANVASED EXPECTED INVENTORIES TO BE FULLY ADJUSTED BEFORE FY 1979.

10. COMMENT: EPA'S EXAMINATION OF THE LEVEL OF INVENTORIES HOLDINGS REPRESENTS A SERIOUS ATTEMPT TO GET A BETTER HANDLE ON A DIFFICULT PROBLEM THAT HAS VEXED ANALYSTS OF THE JAPANESE ECONOMY FOR THE PAST THREE YEARS. HOWEVER, THE TREND ESTIMATES ON WHICH EPA RESTS ITS CASE FOR INVENTORIES TO BE FULLY ADJUSTED BEFORE FY 1979. CONFIDENTIAL

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TORIES BEING CLOSE TO DESIRED LEVELS DO NOT INSPIRE A GREAT DEAL OF CONFIDENCE. THE DEVIATIONS FROM TREND ARE SO LARGE THAT COEFFICIENT OF CORRELATION FOR THE TREND LINE IN BOTH ESTIMATES IS BETWEEN .4 AND .5. THUS EMBASSY BELIEVES THE JURY IS STILL OUT ON WHERE THE INVENTORY ADJUSTMENT NOW STANDS. WHILE THE GOVERNMENT'S STATED EXPECTATIONS OF INVENTORY ACCUMULATION AS A SPUR TO GROWTH ARE UNDOUBTEDLY WELL-INTENTIONED, MOST OUTSIDE OBSERVERS THINK THEY ARE MUCH TOO HIGH IN THE ABSENCE OF AN IMPROVED OUTLOOK FOR FINAL DEMAND. MANSFIELD

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